

# Cash Intensive Businesses Audit Techniques Guide - Chapter 3 – Initial Interview

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## Interview the Taxpayer

The initial interview of the taxpayer sets the stage for the rest of the examination. The primary purpose of the interview is to secure, by conversation with the taxpayer, facts which will present the taxpayer's overall financial picture, an understanding of the operations, and an overview of the recordkeeping practices (that is, type of records maintained and the accounting controls).

In a cash intensive business there may be very few tangible records, so it is important to perform a detailed and meticulous interview. The oral testimony of the taxpayer at this point may turn out to be the only evidence provided, so it must be exhaustive enough to be properly evaluated. The smallest detail gathered may be useful later when no records can be found. The examiner should not abbreviate the interview. A proper interview for a cash intensive business may take two or more hours, so be sure to offer the taxpayer a short break.

Have the taxpayer explain every step from the time cash and other income is received until it is deposited to a bank or spent. Only by taking the time to write down every step in the cash process and noting the name of every person who handles cash, can an examiner find weaknesses in the system if they exist. Don't hesitate to ask candid questions about how cash is handled or how money is spent for both business and personal reasons.

The following paragraphs contain some of the items, which examiners should develop in the initial interview. Also, basic interview techniques below.

### Accounting for Cash

Ask the taxpayer to explain the mechanics of how cash is handled in the business. It is important during the interview to have the taxpayer explain every step of cash handling, beginning with the collection of gross receipts from every source. (TIP: consider using a separate page for each process, for example, the procedure for cash sales recorded in the cash register and how that money is handled and recorded; the procedure for coin collected from vending machines and how that money is handled and recorded; the procedure for cash received at a snack bar and how that money is handled and recorded, etc.) Prepare a flow chart of the cash flow from the time it is received until it is placed into a third party's hands and ask the taxpayer if the flow chart is correct. Include the name of every individual who has contact with the cash at every point. This can later be compared to the CBRS data for accuracy or to determine the credibility of the interview.

Then a similar explanation must be solicited for cash that is paid out as expenditures, including who is authorized to pay cash and where the cash comes from. Write down the taxpayer's exact responses whenever possible.

The examiner must understand the accounting systems used and determine who is responsible for maintaining each type of record.

## Cash on Hand IRM 4.10.4.6. 8. 3 (9/11/2007)

Examiners must ask about cash-on-hand that the taxpayer has access to, including funds available from friends or relatives. Make sure the taxpayer understands that cash includes pocket money plus cash in a safe or other safe location, and cash held in trust by others. If examiners are working with a representative, ask that the taxpayer also appears for the interview so the availability of cash funds can be discussed. Record the taxpayer's responses exactly, using quotations to the extent possible.

Since Cash on Hand and Accumulated Funds are important fundamental aspects of the examination of income and the formal indirect methods, examiners should establish the amount and verify the taxpayer's statements of cash accumulations during the initial interview. This is necessary because:

- Cash on Hand and Accumulated Funds can explain Financial Status Analyses that appear to identify a potentially significant imbalance. The issue can be resolved quickly and with the least amount of burden to the taxpayer if it is addressed early in the examination.
- The information is needed to determine whether a formal indirect method should be used, and which method is most appropriate.
- An adjustment for unreported income can be challenged if the availability of Cash on Hand and Accumulated Funds is not addressed at the beginning of the audit. The after-the-fact "cash in the mattress" • defense cannot be used if the actual Cash on Hand and Accumulated Funds have already been established.

If a taxpayer is vague when answering questions concerning cash, examiners should try to pinpoint amounts by starting with an estimate such as "over or under \$10,000" • and narrowing the range until the taxpayer agrees with a general amount. A commitment should be sought concerning whether an individual had any large accumulations of cash at the beginning or the end of the tax period under audit.

Examiners should ask the taxpayer to make an affirmative statement regarding the existence or nonexistence of Cash on Hand and Accumulated Funds. This statement, and any analysis of the statement, should be included with the income workpapers.

## Business History

Develop data relating to the taxpayer's business history and related businesses. Does the taxpayer own controlling interests in multiple businesses or is he/she a partner? Secure information about accounts receivable, loans receivable, inventories, and a general statement of how the inventories are valued and method used. Ask that a record of the inventory be made available.

If a comparative analysis shows losses or consistently low profits, ask the taxpayer what has caused the problem and what is being done to improve the situation. The taxpayer will be knowledgeable about the industry and can explain any market fluctuations. Remember, no one will remain in a business that does not earn profits.

## Financial Information

Inquire about commingling of business bank accounts and personal accounts of the immediate family. Be specific about all open or closed accounts-business, personal, savings, certificates of deposit, and other forms of money deposits.

Request detailed information about bank loans, personal loans, accounts payable, and other borrowed funds. It may be more practical to cover loans made outside the business, which do not appear in the regular books. Determine whether the taxpayer received any nontaxable income such as gifts, inheritances, or proceeds from life insurance.

Determine the taxpayer's security holdings in stocks, bonds and mutual funds. Obtain a listing of the real estate holdings. Be specific about the personal residence and monthly payments.

Request a record of personal loans made to others "" members of the family, a friend, or someone else.

If certain expenses are paid in currency, ask how this procedure 1) records the expense purchase, i.e. is a receipt retained, is an entry made in the books?, and 2) how is this included in income, i.e. are cash purchases added to bank deposits?

Ask about other assets "" those that appear on the return and those that do not. Find out if financial statements, independent audit report, applications for loans, workpapers used to prepare the return are available.

Sources of income:

Is there any other income, which the taxpayer considered not reportable?

Non-taxable income:

a gift, inheritances, loans, and other non-taxable sources should be tied down as closely as possible early in the audit.

### **Audit Technique Guides:**

Examination Techniques specific to an industry or issues can be found at the Technical Guidance website: <http://sbse.web.irs.gov/tg/default.htm>. These guides include: examples of documents to request, key interview questions, things to look for during tour of business, unique indirect methods, what to look for in books and records, and other known sources of information pertaining to the market segment.

### **General**

Remember, examiners are testing the accuracy of the taxpayer's tax return and especially the sources of gross income. The interview is your opportunity to gather the information not shown on the return.

Ideas for Initial Interview Questions

- Principal Products?
- How long in business?
- Who are your principal customers?
- Ask if the taxpayer has any other source of income.
- How are sales handled?
- Method: cash or accrual?
- Basis for recording?
- If accrual, does he/she have a list of accounts payable and receivable?
- How are prices set?
- What is your markup percentage? (Ask for markup % on each major product)
- How often is inventory taken, by whom?
- Who keeps the books?
- How did they learn recordkeeping?
- What bank accounts maintained?
- Do they deposit everything? Who deposits?
- How do they get cash to spend?
- Check to cash?
- Personal withdrawals “” how handled?
- Safe deposit box?
- How do they record expenses?
- How were the return figures arrived at?
- How are the expenses paid?
- Cash-on-hand
- How much?
- Where located?
- Non-taxable income.
- Pensions, loans, gifts, inheritances?
- Investments:
- Stock?
- Real Estate?
- Major personal property?
- Major Expenses:
- Loan repayments?
- Asset acquisitions? When? How?
- Schooling?

## Summary of Key Points for the Initial Interview

### Interview Purpose

To secure an overall financial picture of the taxpayer and to familiarize yourself with the business activities.

- The taxpayer will be more responsive at this time than later in the audit.
- Answers will be less biased because no issues are at stake.

## Interview Planning

- Have an objective in mind, an outline, and a sequence (as developed by your pre-audit analysis and other available information).
- State your questions simply, in the taxpayer's vocabulary.
- Be an objective, friendly, professional fact-finder.
- Be flexible in your outline.
- Review the appropriate Industry Audit Technique Guide

## Interview Development

- Interviews are very important.
- The examiner should control them.
- Properly documented (but not verbatim notes in front of taxpayer).
- If a question is worth asking, listen analytically to the answer.
- Follow-up leads or discrepancies.
- Be fair and unbiased.

## Importance of Issuing a Summons

When the taxpayer does not have adequate books and records, the agent should make the decision early in the examination to summons third-party recordkeepers (attorneys, enrolled agents, banks, brokers, accountants, etc.) and other third parties, (suppliers, vendors, etc.) to produce records. A summons served on a third party is a third-party contact under IRC section 7602(c), and the appropriate procedures must be followed.

If the taxpayer does not have adequate books and records and the agent needs to summons bank records to complete an indirect method, it is important to issue a summons for all deposited items and checks for each of the known bank accounts. This is necessary to ensure a complete review and identification of documents providing substantiation of taxable or non-taxable income. The deposited items will also help prove that a taxable source exists for the deposits.

The revenue agent should also consider issuing a summons to an uncooperative taxpayer so that the taxpayer could be asked, at the summons hearing, whether he/she had any transfers of funds between the bank accounts that the revenue agent had not already uncovered. The uncooperative taxpayer can also be asked about any other potential sources of non-taxable income, such as the receipt of loans, gifts, or inheritances that were deposited. And, even if the taxpayer refuses to answer the examiner's questions, which information is helpful to demonstrate the revenue agent has tried to follow all reasonable leads.

**NOTE:** Whenever the taxpayer's books and records are deemed inadequate for purposes of an examination of income, the examiner should consider the issuance of an inadequate records notice at the conclusion of the examination. See IRM 4.10.8.16 for procedures to issue an inadequate records notice.

## Authority

The authority to conduct interviews is granted by Internal Revenue Code Section 7602.

### SEC. 7602. EXAMINATION OF BOOKS AND WITNESSES.

(a) Authority to Summon, Etc. - For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax, or collecting any such liability, the Secretary is authorized-

1. To examine any books, papers, records, other data which may be relevant or material to such inquiry;
2. To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
3. To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

#### NOTE:

*IRC section 7701(a) (11) (B) defines Secretary as the Secretary of the Treasury or his delegate. IRC section 7701(a)(12)(A) defines delegate as any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of Treasury directly, or indirectly by one or more redelegations of authority.*

*IRS delegation Order 4 delegates this authority to Revenue Agents.*

The Restructuring and Reform Act of 1998 added IRC section 7602(c) Notice of Contact of Third Parties - General Notice- An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with person other than the taxpayer may be made.

## Time and Place of Examination

IRC section 7605 and the related regulations provide that an officer or employee of the Internal Revenue Service shall fix the time and place of an examination. They further provide that officers and employees of the Internal Revenue Service will endeavor to schedule a time and place that is reasonable under the circumstances.

#### NOTE:

*IRC section 7521(c) provides for the appearance of representatives with valid Powers of Attorney on behalf of taxpayers. This section states “an officer or employee of the Internal Revenue Service may not require a taxpayer to accompany the representative in the absence of an administrative summons.” •*

In short, taxpayers have the right to engage representatives to meet with IRS personnel on their behalf. After a taxpayer has given a representative a valid Power of Attorney, Service personnel will then meet and deal in good faith with the taxpayer’s chosen representative. If however, information necessary for the determination or collection of tax is not, or cannot be provided by the representative, then Service personnel have the authority to administratively summon the taxpayer to personally appear to provide testimony or records deemed necessary by the officer or employee working the case. It should be made clear that the Service cannot compel testimony.

With a valid Form 2848, the power-of-attorney is permitted to practice before the Service. The Power-of-Attorney is restricted to persons recognized or qualified under provisions of Circular No. 230. If a representative is shielding the taxpayer from an examiner, the examiner can bypass the representative and deal directly with the taxpayer. Guidelines are provided in IRM 21.11, Processing Power-of-Attorney. [IRM 4.10.3.2.1.1].